Railways: Network Rail

Standard Note: SN2129

Last updated: 13 January 2015

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Section Business and Transport

This note describes how Network Rail is run, its responsibilities and reforms.

Network Rail is responsible for the operation, maintenance and improvement of railway infrastructure (i.e. the track, signals, bridges and stations) in England, Scotland and Wales. Its primary customers are the train and freight operating companies who run train services over the network. It was set up in 2002 as a company limited by guarantee, run on commercial lines but without shareholders, reinvesting profits in the railway. On 1 September 2014 the company became an arm's-length body of the Department for Transport.

The company has been under pressure for several years due to engineering overruns and concerns over its governance structure and accountability. In May 2011 the McNulty Rail Value for Money study was published. This made a number of recommendations designed to make NR more efficient and accountable and to drive down the costs of the rail industry over the medium term. In response to McNulty, NR announced plans to devolve the way in which it managed and maintained the network into regional units that would be more closely aligned with the train companies in those areas. In March 2012 the Government responded to McNulty by proposing a revised governance structure for NR.

In 2013 it was announced that NR would be reclassified as a central government body in the public sector; the main effects of this are that NR's debt (estimated to reach £50 billion by 2019) has moved onto the Government's balance sheet and the Government is able to exert more direct control over pay and strategy. This took place on 1 September 2014.

Alongside the reform process NR, the regulator and the Government have completed the quinquennial Periodic Review, whereby the industry has set out the improvements it intends to deliver to the rail network between 2014 and 2019 and at what cost. It is anticipated that this will help deliver some of the efficiency targets described in McNulty, in order to bring down the overall costs of the railway.

Information on other railway matters can be found on the Railways Topical Page of the Parliament website.

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1 What is Network Rail?

1.1 Origins, 2001-02

Network Rail (NR) was established in 2002 as a company limited by guarantee (CLG), broadly as set out by the then Secretary of State for Transport, Stephen Byers, in his statement of October 2001.[1] The company took over the assets and liabilities of Railtrack plc and its role as network operator. The company was 'not for profit', which did not mean it could not make a profit but that to do so was not its primary aim. Any operating surplus would be reinvested in the rail network. The Government would not be involved in NR's management strategy for delivering its outputs or in its day-to-day operations. Operational responsibility would lie with the company's own management team. They would decide how best to deliver the outputs set by the Government as well as other local-level decisions. It would also independently set pay and remuneration for senior executives.

The *Railways Act 1993* provided the legal framework for the privatisation of British Rail and the introduction of a new structure for the rail industry. The Act received Royal Assent in November 1993 and many of the principal changes were brought into effect on 1 April 1994.[2] A separate Government-owned company called Railtrack was set up to look after the track

1 HC Deb 15 October 2001, cc954-76
2 for more information about rail privatisation, see HC Library note SN1157

and was sold to the private sector in May 1996. Under Part IV of the *Transport Act 2000* the Office of Rail Regulation (ORR) was given more powers over Railtrack's investment plans and the Strategic Rail Authority (SRA) was set up. On 7 October 2001 the then Secretary of State for Transport, Stephen Byers, applied for Railtrack to be put into administration. It came out of administration on 3 October 2002 when NR took over many of its responsibilities.

NR was incorporated as a company on 22 March 2002. The bid of NR for Railtrack plc was announced on 25 March 2002.[3] Under the terms of the proposal, the then Labour Government (through the SRA) provided a £300 million subsidy to NR (this required approval from the European Commission). The Government justified the payment by saying that the proposal would take Railtrack out of administration months earlier than expected, saving the taxpayer £1 million per day.[4] NR agreed to pay £500 million to Railtrack Group, to be passed on to investors. A sale and purchase agreement for the entire issued share capital was entered into on 27 June 2002. The completion of the sale was subject to conditions including the approval of Railtrack Group shareholders (agreed on 23 July 2002); approval of the European Commission for any state aid in the Government's support for NR (agreed on 17 July 2002);[5] and the discharge of the Railway Administration Order made in respect of Railtrack (achieved on 1 October 2002). Railtrack Group and NR also entered into an agreement on 27 June 2002 for the acquisition by NR of the right to operate, manage and maintain the Channel Tunnel Rail Link (HS1) and the concession to manage St. Pancras station.

The statement by the then Secretary of State, Alistair Darling, of 27 June 2002 said:

> Railtrack Group and Network Rail have now concluded a sale and purchase agreement to acquire Railtrack plc. I would like to set out in some detail the terms of that agreement. In line with its original offer, Network Rail will pay £500 million—of which £300 million will be provided by the Government—as well as taking over Railtrack's debt, which now stands at £7.1 billion. This includes loans from the European investment bank and the German bank, KfW, totalling just over £1 billion, which Network Rail plans to assume.
>
> In parallel, London and Continental Railways is acquiring from Railtrack its interest in the first phase of the channel tunnel rail link for £295 million. At a cost of £80 million, Network Rail will acquire the right to operate, manage and maintain the channel tunnel rail link and the concession to manage St. Pancras station. I can tell the House that Network Rail has already secured up to £9 billion of bridge financing from commercial banks to fund its acquisition costs and to refinance Railtrack's existing debt, as well as to fund the immediate operation of the railway.
>
> Network Rail will also put in place additional commercial financing of up to £7 billion for its medium-term requirements. This is necessary to cover operational expenditure as well as to cover substantial cost overruns inherited from Railtrack, which will have to be met. Network Rail will also need—as would any owner and operator—access to back-stop contingency funding. For this reason, the SRA will provide additional standby credit facilities; this contingency funding of last resort has been set at £4 billion. Further details of this funding and of the short-to-medium-term standby credit facilities offered to Network Rail by the Strategic Rail Authority are set out in the two Minutes that I am

3 HC Deb 25 March 2002, cc582-595
4 ibid.
5 HL Deb 30 July 2002, 172WA

> laying before the House in the normal way. The House will also wish to know that the Rail Regulator has today issued a statement setting out his approach to a request for an early regulatory review.
>
> These are large sums by any standards, but they are necessary, given the size of the task facing Network Rail, and they would be needed by any successor to Railtrack. There is no escaping the fact that Britain's railways need very large-scale investment—investment that we believe is essential. It is because of the need for long-term sustained investment that the Government are, through the 10-year plan, increasing the average annual investment in the railways—on top of continued support for running costs—to £4.6 billion. That is more than three times the annual average in the 10 years prior to 1997 (…) [6]

1.2 Reclassification as arms-length body, 2014

On 1 September 2014 NR became an arms-length body of the Department for Transport (DfT). This came about following a decision by the Office for National Statistics (ONS) to reclassify NR for statistical reasons; it was not due to any changes in the circumstances or performance of NR. It is not intended to change the railway industry's structure or to affect the day-to-day operations of the rail network. The ONS' decision has no effect on fares, performance, punctuality, safety and timetables. ORR remains the economic and safety regulator for the railways. Further to the reclassification, the Government and NR have agreed that NR will be subject to the *Freedom of Information Act 2000* in relation to its public functions. This requires secondary legislation, which the Government "will be bringing forward at the next opportunity".[7]

On 17 December 2013 the ONS announced that, following a review, NR would be classified as a central government body in the public sector from 1 September 2014. The most significant effect of this is that the company's net debt, currently some £30 billion – but due to rise to approximately £50 billion by the end of the decade – now appears on the Government's balance sheet.[8] There is a further question as to the extent to which the Government (in the person of the Secretary of State for Transport) can or will become more involved in the day-to-day running of NR, particularly when things go wrong (e.g. engineering overruns) and in the context of senior executive remuneration.

NR's borrowing (effectively a debt) has always been backed by the taxpayer but the ONS has counted it as private rather than public debt in the past and so it has not appeared on the Government balance sheet. The Memorandum of Understanding between NR and the Government, published alongside the announcement, states that: "the ONS' decision to reclassify Network Rail for statistical purposes arises only out of the new Eurostat reporting rules. It is not due to any other change in the circumstances or performance of Network Rail".[9]

The Government makes this point to differentiate the reclassification from others that have happened in the past, for example in the late 1990s London & Continental Railways was

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6 HC Deb 27 June 2002, cc971-989

7 DfT, *Network Rail Framework Agreement*, September 2014, p9

8 DfT, *ONS decision on the classification of Network Rail*, 17 December 2013; for the debt figures, see table 13.4, page 501 of the *ORR Final Determination for CP5*, October 2013

9 DfT/NR, *Memorandum of Understanding between the Department for Transport and Network Rail*, 17 December 2013, para 13

brought into the public sector after the Government of the day intervened in the operation of the company.[10]

The Government has been relatively relaxed about the change for several years now (though performance issues over Christmas 2014/New Year 2015 may change that). For example, the then Secretary of State for Transport, Philip Hammond, told the Transport Committee in July 2010 that he did not have any "theological focus on keeping the debt off balance sheet". He then referred to the 2010 bonus round, and said: "I wrote to the board of Network Rail ... making clear that the government did not approve of the proposed large executive bonuses ... I consciously risked the national statistician deciding that the debt had to be classified differently but I say again we will not allow our relationship with Network Rail to be dictated by an artificial accounting convention".[11]

This decision has significant knock-on impacts for governance and financing (see below).

1.3 Governance and executive remuneration

Corporate governance

The Framework Agreement, published in September 2014, sets out how NR is to be governed following reclassification.

NR retains the commercial and operational freedoms it had prior to September 2014; its Board is responsible to its Members (see below), the Government and other stakeholders. Amongst other powers, the Secretary of State is the 'Special Member', as that role is defined in the Articles of Association; appoints the Chair of NR and has the right to approve the Board's choice of Chief Executive; approves the triennial remuneration policy for executive directors and sets pay for the Chair and non-executive directors; agrees the Membership Policy and has the right to remove all of the Members.[12] The Framework Agreement states:

> The Secretary of State will appoint the Chair in accordance with the Commissioner for Public Appointment's principles.
>
> The Secretary of State has the power to dismiss the Chair.
>
> The non-executive Directors will be selected by the Nominations Committee, which must consult with the Secretary of State when developing their recommendations.
>
> The Chief Executive will be selected by the Nominations Committee. The Nominations Committee's recommendation will be subject to approval by the Secretary of State, who will also be consulted while they are developing their proposals.
>
> A Membership Policy will be agreed between the Secretary of State and the Board.
>
> The Secretary of State will appoint a Membership Selection Panel which will act independently and recommend Members for selection. The Secretary of State has the right to approve or reject the Panel's recommendations.
>
> Members have the right to re-elect members of the Board as set out in the Articles of Association.

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10 for more information, see HC Library note SN267

11 Transport Committee, *Evidence from the Secretary of State for Transport*, HC 359, 26 July 2010, Q18

12 op cit., *Network Rail Framework Agreement*, p10

> Network Rail will comply with best practice corporate governance requirements, including Corporate Governance in Central Government Departments: Code of Good Practice and the UK Corporate Governance Code.[13]

NR's Members hold the Board to account for its management of the company. There are between 30 and 50 public Members; the Secretary of State is the Special Member, with particular rights in relation to NR's constitution.[14] Generally, the role of the Members is:

> … similar to the role of shareholders in public limited companies except that public members have no financial interest in Network Rail. Unlike listed public limited companies which have large shareholder bases, our members' votes carry much more influence. Each member's vote really counts as no one member has greater voting power than another. It is strictly one member, one vote.[15]

The Framework Agreement states:

> In particular, the Members:
>
> - monitor the Board's management of the performance of Network Rail;
> - engage with the Board to raise queries or express views objectively and in an informed way where Board performance falls below expected standards, outputs or targets, and acknowledging progress and success where achieved;
> - scrutinise the governance procedures and processes designed to facilitate the delivery of the strategic objectives of Network Rail;
> - participate actively in the meetings of Members; and
> - attend and vote at general meetings of Network Rail Limited.[16]

Executive remuneration

In terms of executive remuneration, the Secretary of State sets pay for the Chair and the other non-executive Directors. The Framework Agreement provides that reward and incentivisation for executive Directors (including the Chief Executive) be set according to a three-year remuneration policy, developed by the Remuneration Committee and subject to approval by the Secretary of State and a vote by Members.[17] NR's current Chief Executive is Mark Carne.

In a January 2014 letter to the Chairman of the Transport Select Committee, Louise Ellman, the Secretary of State for Transport, Patrick McLoughlin, said that with regard to general principles, it was "vitally important that Network Rail is able to secure the right talent and leadership to deliver for the country. At the same time, pay should be proportionate and closely related to performance".[18] The *Sunday Times* reported in September 2014 that the Treasury had instructed NR to "limit the number of staff who are paid more than the prime

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13 ibid., p16
14 information on NR's current public Members can be found on the NR website [accessed 8 January 2015]
15 NR, *Our Members* [accessed 8 January 2015]
16 op cit., *Network Rail Framework Agreement*, p13
17 ibid., p20
18 *Letter from Patrick McLoughlin to Louise Ellman*, 16 January 2014

minister's £142,500 salary, and secure Treasury approval to pay anyone more than £220,000".[19]

There has been a question, post-reclassification, as to the extent to which the Secretary of State might intervene to stop or reduce bonuses paid to executive directors, in particularly the Chief Executive, were there to be significant performance issues or missed targets. This followed a pointed example from 2007/08 when there was significant disruption to the rail network over the Christmas 2007 period. The Secretary of State at the time, Ruth Kelly, was pressed to intervene in NR's remuneration award and to prevent the then Chief Executive from claiming a bonus in light of those failures. She said:

> First, bonus setting is not for the Government; it is not my role as Secretary of State for Transport to set the bonuses of Network Rail's management. However, I sympathise with those who, understandably, feel angry about the delays and overruns in the Christmas and new year period.
>
> Secondly, bonuses are set by Network Rail's remuneration committee, which is chaired by an independent non-executive director and acts according to a management incentive plan that takes into account whether a licence has been breached or is likely to be breached in future.[20]

There were severe disruptions to services over Christmas 2014, leading to similar questions as to the award of bonuses. Mr McLoughlin said that that "Network Rail's bonuses should reflect what has happened", but made no further comment as to his role in setting or agreeing that bonus.[21] In the event, Mr Carne offered to take a significantly reduced bonus of around £34,000, or five per cent of his salary.[22]

Prior calls for reform

By way of background, prior to the reclassification in 2014 there had been calls for NR's corporate structure to be overhauled. These largely date back to 2008; for example 'the People's Rail' campaign led by the Co-operative Party called for NR Members to elect a Members Council which would replace the role fulfilled by the Membership and questioned whether the system was open to cronyism and institutional inertia;[23] and the Transport Select Committee repeatedly questioned how NR was run.[24]

In August 2008 the Office of Rail Regulation (ORR) published a report by KPMG on aspects of the governance arrangements at NR and options for change. The ORR said that, amongst other things, there was a 'lack of clarity' about the role of Members and their selection.[25] In March 2009 there were reports about the contents of a study conducted by PricewaterhouseCoopers on behalf of NR members, looking at the organisation's corporate governance. The *Financial Times* reported that according to PwC "understanding of the company's corporate governance arrangements is poor and that members are unsure of their

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19 "Osborne puts straitjacket on rail bosses to curb runaway pay", *Sunday Times*, 7 September 2014
20 HC Deb 8 January 2008, c172
21 HC Deb 5 January 2015, c25
22 "Mark Carne, Network Rail chief, will not take bonus", *The Daily Telegraph*, 30 December 2014
23 Co-operative Party, *The People's Rail: a mutually run, publicly accountable Network Rail*, July 2008, executive summary
24 Transport Committee, *The future of the railway* (seventh report of session 2003-04), HC 145, 1 April 2004, para 59; and: Transport Committee, *Delivering a sustainable railway: a 30-year strategy for the railways?* (tenth report of session 2007-08), HC 219, 21 July 2008, paras 63-64 & 66
25 ORR press notice, "ORR publishes report into aspects of Network Rail's governance", 8 August 2008; full report available on the archived ORR website

role [and] decision-making could be more effective if the number of members were reduced…".[26]

In November 2009 NR announced a number of reforms as a result of its' Members' internal governance review.[27] However, one key change failed to garner enough support: a vote on reducing the number of Members over time was tied at 36 for and against. Consequently, NR chose to "leav[e] this proposal in abeyance for the time being".[28]

Following months of allegations in the press, in December 2010 NR agreed to an independent inquiry into accusations of financial impropriety at the company.[29] The report by Antony White QC, published in May 2011, found that the allegations were groundless.[30]

Before the 2010 election, both the Conservatives and the Liberal Democrats had promised to reform NR in some way. The Liberal Democrat Manifesto for the 2010 election stated that that Party would "overhaul Network Rail to put the interests of passengers first and bring it under the Freedom of Information Act to make it more open".[31] The Conservative Manifesto contained a commitment to "reform Network Rail to make it more accountable to its customers".[32] This idea was previously fleshed put in the Party's 2009 rail policy document.[33] The Coalition Agreement, published in May 2010, stated the Government's intention to "make Network Rail more accountable to its customers".[34] In the event, the Government's March 2012 rail reform command paper stated that the Government would continue to encourage NR and the industry as a whole to develop governance reforms which protect taxpayer interests; allow customers to hold NR to account; promote the passenger interest; and support an 'effective remuneration policy'.[35]

1.4 Finances

NR is funded via revenue and debt issuance. Post-reclassification, future borrowing will be via a loan facility agreement from the Government. NR's revenue comes from three sources:

- Grants from the Department for Transport and Transport Scotland;
- Commercial property income; and
- Track access grants from its customers (train and freight operating companies).

26 "Network Rail too focused on watchdog targets, says study", *Financial Times*, 3 March 2009

27 NR press notice, "*Greater transparency and accountability: Network Rail evolves corporate governance*", 18 November 2009

28 ibid.

29 for further information, see, e.g.: TSSA press notice, "Independent Inquiry agreed into alleged misuse of public funds at Network Rail", 22 December 2010; and: "Network Rail faces official inquiry into claims of exorbitant payoffs", *The Observer*, 31 October 2010

30 NR press notice, "Network Rail welcomes publication of White report", 24 May 2011

31 Liberal Democrats, *Liberal Democrat Manifesto 2010*, April 2010, p78

32 Conservative Party, *Invitation to join the Government of Britain: the Conservative manifesto 2010*, April 2010, p24

33 Conservative Party, *Conservative rail review: getting the best for passengers*, February 2009, section 4.2

34 HMG, *The Coalition: Our Programme for Government*, May 2010

35 DfT, *Reforming our railways: Putting the customer first*, Cm 8313, March 2012, para 4.54

In 2009/10 about two-thirds of NR's revenue was through direct government Network Grant.[36] In 2013/14 the Network Grant accounted for approximately 55 per cent of NR's income.[37]

In terms of its debt, forecast to increase to £50 billion by 2019, NR previously raised bonds in the capital markets with a UK Government guarantee to fund capital expenditure and to re-finance existing debt. As a consequence of reclassification, NR will no longer be issuing bonds but will instead be borrowing direct from Government via a £30.3 billion loan facility designed to cover its CP5 (2014-19) funding requirements. Existing UKRAIL bonds are unaffected by this change.[38] The loan agreement allows NR to borrow direct from the Government rather than the markets: it is intended that this will improve value for money for taxpayers by reducing the cost of borrowing.[39]

By way of background, after NR took over the network from Railtrack it also received a loan from the Government via the SRA. In September 2004 the Labour Government laid minutes before Parliament about new contingent liabilities relating to Government support for NR's Debt Issuance Programme (DIP). The key element of this support was the Financial Indemnity (FI) provided by the SRA benefiting all debt issued under the DIP. The FI came into effect on 29 October 2004. On 26 June 2005 a transfer scheme made by the Secretary of State under the *Railways Act 2005* came into effect. The scheme transferred the SRA's rights and liabilities under the FI, and its other support for NR borrowing, to the Secretary of State.[40]

In July 2006 it was reported that NR was planning to raise funds independently through bank debt or bonds, eliminating its need for government subsidy.[41] In April 2007 NR announced that it was launching an index-linked bond programme,[42] which by 3 May had raised £1 billion.[43] In June 2008 it was reported that NR planned to raise a further £10 billion from 2009.[44] However, in February 2009 it was reported that NR had decided to delay its plans following a poorer-than-expected credit rating and a "tight funding settlement" from the Regulator.[45] In total, the NR Debt Issuance Programme was comprised of the following:

- £40 billion Multicurrency Note (MCN) programme
- £4 billion Euro and US Commercial Paper programmes

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36 DfT/ORR, *Realising the Potential of GB Rail: Final Independent Report of the Rail Value for Money Study*, May 2011, p17

37 £3.45 billion of £6.3 billion total income, see: NR, *Annual Report and Accounts 2014*, p113 and ORR, *2013-14 Annual Statistical Release: Rail Finance*, August 2014, p8

38 NR, *Our governance structure* [accessed 12 January 2015]; for the debt figures see: table 13.4, page 501 of the *ORR Final Determination for CP5*, October 2013

39 DfT, *Network Rail loan agreement*, September 2014

40 DfT, *Departmental minute: Government support for Network Rail borrowing annual update,* 5 July 2006, paras 2 and 3; the Government laid a new minute in July 2010, see: DfT, *Departmental minute: Government support for Network Rail's borrowing*, 2 July 2010

41 "Network Rail ends reliance on state funding", *Financial Times*, 31 July 2006

42 NR press notice, "Network Rail launches index-linked bond programme", 25 April 2007

43 "Network Rail raises £1bn in bond sale", *Financial Times*, 3 May 2007

44 "Network Rail to ease ties to Government by raising £10bn on the capital markets", *The Times*, 7 June 2008

45 "Network Rail delays debt plan", *Financial Times*, 6 February 2009

McNulty Rail Value for Money Study, 2011

In the context of anticipated cuts to the Department for Transport's budget (irrespective of the outcome of the coming General Election), the then Secretary of State for Transport, Lord Adonis, announced in December 2009 that he had asked Sir Roy McNulty[46] to undertake a review of value for money in the UK rail industry.[47] Sir Roy published his final report in May 2011. He found that there had been a net increase of £1.7 billion in Government subsidy between 1996/97 and 2009/10. Since 1996/97 one of the principal drivers had been an increase in NR's net revenue requirement of £2.7 billion. Overall, net Governmental support for the rail industry peaked in 2006/07 at £6.8 billion, 49 per cent of the combined total of Government support and (passenger and freight) revenue. Over recent years, net Government support had fallen, although it was still significant at £4.6 billion, 37 per cent of the combined total.[48]

Sir Roy went on to explain how NR's Regulatory Asset Base (RAB) works:

> Total industry cash expenditure does not however feed directly into Government subsidy requirements due in particular to the way NR is financed. NR is funded through a conventional regulatory approach (the "building block" approach) where renewals and enhancement expenditure is mostly capitalised and added to the Regulatory Asset Base (RAB). This is paid for through an amortisation allowance and an allowed return on the RAB.
>
> These mechanisms allow NR to finance its debt and the renewal of its infrastructure assets. Funding of capital expenditure in the current year is spread over future years, ensuring that future users of the railway pay for infrastructure improvements from which they are benefiting. NR's revenue requirement is the total of operating and maintenance expenditure, amortisation and return on the RAB.[49]

He stated that NR's expenditure had been higher than its revenue requirement for most of the post-privatisation period. The particularly high level of expenditure since 2000/01, principally addressing the renewals backlog, translated into significant increases in the RAB, with the RAB standing at £35.7 billion at March 2010, an increase of £29 billion since 2001/02. He concluded that the increasing level of NR's RAB, and the debt underpinning it, resulted in a significant base cost for the rail network going forward.[50]

Sir Roy made a number of recommendations relating to how NR could bring down its costs and manage and maintain the infrastructure more efficiently. He acknowledged that NR had already done some work on delivering savings, particularly in terms of its 'Transformation Programme':

> At the start of the current control period in 2009/10, NR embarked on its Transformation Programme in order to:
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> - achieve the efficiency improvement targets set by the ORR for CP4;

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46 the former Chairman of the Civil Aviation Authority

47 the *Terms of Reference* are available to view on the DfT Archive website

48 op cit., *Realising the Potential of GB Rail: Final Independent Report of the Rail Value for Money Study*, section 3.4.1

49 ibid., section 3.4.2

50 ibid., section 3.4.2

- transform "how" it does things as well as "what" it does, increasing the focus on the service provided to rail users, customers and other stakeholders; and
- provide a strong foundation for longer-term sustainable improvements in affordability and value for money[51]

In terms of NR's future delivery of efficiency savings, Sir Roy concluded as follows:

> There are a large number of complex systems issues that NR and its predecessor Railtrack have been working on for over 10 years. However, the pace of improvement has quickened since 2008 and the current Transformation Programme is maintaining that trend, and is doing a lot to change the behaviours and culture of its employees.
>
> In terms of technical coverage, there is generally a strong synergy between the aspirations of the Transformation Programme and the Study, particularly in the asset management and supply chain management areas.
>
> The Transformation Programme is well conceived and is tackling the right issues. If it continues in the way it has been going there is a high likelihood of success.
>
> An area of concern raised several times during the Study is how NR's recent move to decentralisation, coupled with a change of senior management, aligns with the Transformation Programme.
>
> The move to decentralisation is clearly aligned with the findings of the Study, and although elements of the Transformation Programme may need to be adapted to reflect the new approach, the Study considers that the closer working between NR and Train Operating Companies (TOCs), coupled with the closer alignment of incentives, should accelerate many of the necessary changes.
>
> It is important that NR can quickly demonstrate to its staff how the Transformation Programme aligns with the move to devolution to prevent its staff being distracted or abandoning the efficiency initiatives it has already started.[52]

The report made many other, technical, recommendations about supply chains, asset management etc.

2 What does Network Rail do?

NR is responsible for the railway infrastructure (i.e. the track, signals, bridges and stations). Its main customers are the train and freight operating companies who run train services over the network. NR's role includes:

- operating the network;
- managing performance;
- directing service recovery;
- setting timetables;
- allocating capacity;

[51] ibid., section 15.3
[52] ibid., section 15.7

- leading industry planning; and
- maintaining, renewing and developing the network.

NR owns all the railway stations in Great Britain but, with the exception of the 18 major stations which it runs (10 of which are the big London terminals), they are leased to the train operating company (TOC) which is the main user of that station.

Although Network Rail assumed a number of responsibilities from Railtrack when it took over the rail infrastructure in 2002; it acquired a range of other responsibilities as a consequence of Labour's 2004 rail White Paper, consequently legislated for in the *Railways Act 2005*.

The post-privatisation maintenance regime saw responsibility for asset stewardship transferred to infrastructure maintenance companies. About £5 billion of NR's £6 billion annual cost base was spent on external contractors. NR carried out a full review of how railway maintenance was carried out and announced in October 2003 that it would take direct control throughout the country.[53] Under the New Maintenance Programme (NMP) NR determines what work is to be done, when it is to be done and carries out inspections to ensure that it has been completed to a high standard. Renewals work remains with the private sector. Responsibility for major improvements moved from Railtrack to the SRA and consequently to the DfT. A further reorganisation of maintenance work was carried out in early 2010, despite concerns from the Regulator and rail unions.[54] NR's maintenance monopoly on the rail network came to an end when the Channel Tunnel Rail Link (HS1) was let to the private sector in November 2010.[55]

The 2004 White Paper announced that NR would be given new powers over timetabling and industry co-ordination. It would also be the body held accountable for the sector's punctuality and cost control. NR is therefore accountable under regulatory and contractual arrangements for the operational management of the network, and for co-ordinating the industry's planning. In addition to retaining its core responsibilities for operating, maintaining and renewing a safe national rail network, from 4 April 2005 NR also took on responsibility for:

- drawing up route utilisation strategies (RUS) for agreement by government that make best use of the network's capacity;
- devising efficient and clear timetables based on those route strategies, and input from train companies;
- directing network operations, and getting services back on track following incidents and delays;
- driving up the operational performance of the network;
- devising and delivering infrastructure maintenance and renewals, as well as delivering enhancements to the network as appropriate; and

53 full details of the NMP are given in section 4 of the *2003 Technical Plan*, pp14-15
54 "Network Rail shake-up 'could put passengers at risk'", *The Times*, 4 March 2010
55 DfT press notice, "UK Government sells right to operate its first High Speed Railway for £2.1bn", 5 November 2010

- accounting publicly for performance.[56]

The Government also said that it would not be involved in NR's management strategy for delivering the specified outputs or in its day-to-day operations. Operational responsibility lies with the company's own management team. They decide how best to deliver the outputs set by the Government, such as where track needs replacing, and where to target their efforts on strengthening embankments or maintaining signalling systems, as well as on other local-level decisions. Where proposed changes fall outside the Government's output specifications, or where a case has to be made for additional enhancement funding, the Government's approval is required. Other service changes do not normally require Government sign-off. NR is free to deploy any profits that it earns as it sees fit in improving the network, which may include sponsorship of enhancement schemes. The reclassification (see above) did not change this.

3 How is Network Rail regulated?

The Office of Rail Regulation (ORR) has a range of statutory powers to set the contractual and financial framework within which NR operates the network, ensuring that the company carries out its activities efficiently and well, and that it is appropriately funded. The level of income required by NR is regulated by the ORR via a process of quinquennial periodic reviews and, where appropriate, interim reviews.

3.1 Network Licence

ORR regulates NR under its Network Licence. There are six parts to the licence, covering different areas of operation: network management and timetabling; restrictions on activities; dealings with third parties; information requirements; corporate matters; and standard industry obligations.

As far as passengers are concerned, Part A (network management and timetabling) is probably the most relevant and important. Under Part A (Condition 1), NR's network management obligations are to secure:

> (a) the operation and maintenance of the network;
>
> (b) the renewal and replacement of the network; and
>
> (c) the improvement, enhancement and development of the network,
>
> in each case in accordance with best practice and in a timely, efficient and economical manner so as to satisfy the reasonable requirements of persons providing services relating to railways and funders, including potential providers or potential funders, in respect of:
>
> > (i) the quality and capability of the network; and
> >
> > (ii) the facilitation of railway service performance in respect of services for the carriage of passengers and goods by railway operating on the network.[57]

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56 HC Deb 9 March 2005, c110WS; and: ORR, *Notice of proposed modifications to network rail's network licence: industry performance and planning and route utilisation strategies*, April 2005

57 ORR, *Network Licence granted to Network Rail Infrastructure Limited (As at 1 April 2014)*, p5

NR has a general duty to achieve the purpose set out above to the greatest extent reasonably practicable having regard to all relevant circumstances including its ability to finance its licensed activities. There are further, specific obligations in Condition 1 for NR to:

- consult with a view to planning the means by which it will comply with the general duty;
- prepare and provide to ORR plans, strategies or other documents demonstrating its compliance and proposed compliance with the general duty (including a delivery plan and route utilisation strategies);
- co-operate with any potential provider or potential funder so as to identify ways in which its reasonable requirements in respect of the allocation of capacity on the network could be satisfied; and
- develop the policies and criteria it will apply in respect of the maintenance, renewal, replacement, improvement, enhancement and development of relevant assets.[58]

Specifically on timetable planning, Condition 1 requires NR to

> (a) run an efficient and effective process, reflecting best practice, for establishing a timetable, and any changes to it; and
>
> (b) where necessary and appropriate, initiate changes to relevant industry processes,
>
> so as to enable persons providing railway services and other relevant persons to plan their businesses with a reasonable degree of assurance and to meet their obligations to railway users.[59]

The ORR can fine NR for any breaches of its licence. To date there have been 18 breaches of its licence by NR (not including earlier breaches incurred by Railtrack). The amount of fines imposed for these breaches totals approximately £72.75 million.[60] By far the largest of these was issued in July 2014 when NR was ordered to return £53.1 million to funders (i.e. train operating companies) for failure to deliver its agreed obligations in 2013-14.[61] Prior to this the largest penalty had been for £14 million in 2008 for the "systemic weaknesses in Network Rail's planning and execution of engineering work, which represent a serious continuing breach of its licence", exposed during Christmas 2007/New Year 2008.[62]

At time of writing, ORR is investigating whether NR breached the terms of its licence over Christmas 2014/New Year 2015 delays and disruptions caused by overruns of two pieces of engineering works: at Holloway, north of King's Cross station, and at Old Oak Common, west of Paddington station. NR's own investigation into the incident concluded that equipment failures and insufficient contingency were the two main causes of disruption.[63]

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58 ibid., pp5-9

59 ibid., p9

60 ORR, *Licence enforcement action taken by us to date* [accessed 13 January 2015]

61 *ORR Breach Letter to Network Rail*, 7 July 2014

62 ORR press notice, "ORR confirms £14m penalty for Network Rail", 9 May 2008

63 NR, *A review into the causes of passenger disruption affecting King's Cross and Paddington station services on 27 December 2014*, 12 January 2015, pp7&9

3.2 Quinquennial Periodic Review

The rail industry Periodic Review takes place every five years. Central to the review is ORR's assessment of what NR must achieve, the money it needs to do so, and the incentives needed to encourage delivery and outperformance. The review also looks at how NR should work more closely with train operators, suppliers and others to reduce costs and deliver more for customers. ORR's objective for the review is as follows:

> To protect the interests of customers and taxpayers by ensuring our determination enables Network Rail and its industry partners to deliver or exceed all the specified outcome and output requirements safely and sustainably, at the most efficient levels possible comparable with the best railways in the world by the end of the control period.[64]

Each review covers what is called in rail industry planning a 'control period'. We are currently at the beginning of Control Period 5 (CP5), which runs from 2014 to 2019. The outputs and the funding that NR must deliver over this period were set during the Periodic Review 2013 (PR13).

ORR started the periodic review for CP5 in 2011. The Government published its High Level Operating Statement (HLOS) and Statement of Funds Available (SoFA) in July 2012; these set out the major projects it wished NR to deliver in CP5 and the funding it was prepared to offer to pay for it. This included already committed projects (i.e. that had previously been announced and were in some cases already underway) such as Crossrail, Thameslink, major stations upgrades at Reading and Birmingham New Street, electrification schemes and elements of the 'Northern Hub'. It also included new schemes such as an 'electric spine' on parts of the Brighton Main Line, the Midland Main Line and East-West Rail and electrification of the Welsh Valleys line and the Great Western Main Line in the Thames Valley. The SoFA for CP5 was £16.8 billion.[65]

ORR published a draft determination for consultation in June 2013 and its final determination in October 2013. Its main decisions were as follows:

- delivering what matters to passengers – nine out of ten regional, Scottish, Southeast and London trains to run on time, with fewer serious delays and cancellations on mainline long distance services;
- reducing engineering works disruption to passenger trains by 8% and freight trains by 17%;
- running the network for £38bn from 2014-19;
- reduced day-to-day costs by £1.7bn less than Network Rail said it would cost;
- asking Network Rail to deliver efficiencies of nearly 20% compared to the end of CP4;
- investing over £12bn on improving the network and its facilities;

[64] ORR, *Periodic review 2013 (PR13) guide* [accessed 13 January 2014]
[65] DfT, *High level output specification 2012*, 16 July 2012; NOTE it does not include HS2

- investing over £21bn on day-to-day network running, including £17bn on maintenance and renewal of track and equipment (over £5bn on maintenance and over £12bn on renewals); and

- maintaining high safety standards, including investing £250m to improve worker safety and £109mn on improving safety at level crossings.[66]

In terms of **value for money** ORR stated that NR was unlikely to make its efficiency target of 23.5 per cent by the end of CP4 (31 March 2014), and asked it to make total efficiencies of nearly 20 per cent in CP5 compared to the end of CP4. ORR also indicated that further savings of £1.7 billion could be made on running costs for the railways over CP5. ORR indicated that it would look closely at how NR continues to devolve its business to route level;[67] check that it spends money efficiently (i.e. that efficiencies are genuine rather than just deferred spend); require NR to be more open about how taxpayers' money is spent and what it achieves; and report on how all parts of the industry perform and remedies for poor performance. ORR concluded that if NR can deliver these efficiencies over CP5 it "will have achieved the challenging targets set out by the government's independent consultant Sir Roy McNulty in his 2011 report" [see above].[68]

In terms of **performance**, ORR requires NR to ensure that an average of 92.5 per cent of passenger trains arrive on time and to keep the proportion of cancellations and significantly late trains (CaSL) to an average of 2.2 per cent of passenger services by the end of CP5.[69]

Finally on **safety**, ORR has provided around £109 million for improving safety at level crossings (these account for half of the potentially catastrophic risks on the current network). This includes closing around 500 level crossings by the end of CP5. It has also provided £250 million to help improve track worker safety and will require more clarity from NR on how progress on safety will be measured and tracked (e.g. how it will cut train accident risk by 50 per cent) and what it is doing to improve the occupational health and the safety of rail industry employees.[70]

4 The future

4.1 Vertical integration?

In his May 2011 report (see above), Sir Roy McNulty recommended that NR and the train operating companies (TOCs) look at the potential benefits of closer working. To achieve this there should be more transparency of information and a vertically integrated exemplar of a regional unit.[71] These ideas should be taken in the context of moves NR had already made to restructure itself into regional business units, in anticipation of closer working with TOCs [see

[66] ORR, *Our decisions for 2014-2019* [accessed 13 January 2015]; for full details see: ORR, *Periodic Review 2013: Final determination of Network Rail's outputs and funding for 2014-19*, October 2013

[67] in February 2011 NR announced that it was devolving accountability to the route level so that each route managing director would, in effect, be running their own infrastructure railway business with significant annual turnover and resources, see: NR press notice, "Network Rail moves to create devolved business units", 21 February 2011

[68] op cit., *Our decisions for 2014-2019*

[69] ibid.

[70] ibid.

[71] op cit., *Realising the Potential of GB Rail: Final Independent Report of the Rail Value for Money Study*, section 23.1.2 and 25.2.1

footnote 66, above]. In January 2012 it was reported that NR was in talks with South West Trains to form a joint management team for the franchise, essentially vertical integration.[72]

The Government's March 2012 command paper on rail reform indicated that the Government intended to look at how vertical integration could be delivered:

> ... building on alliancing and concessions, and subject to EU legislation, we will explore how full integration on discrete parts of the network might potentially drive further efficiency benefits and investment, helping both track and train to align around service delivery. This is most likely to be an option on Network Rail routes such as Wessex and Anglia where the majority of passenger train services are run by a single train operator.[73]

The industry welcomed the idea of vertical integration. The Association of Train Operating Companies (ATOC) made this case in a March 2011 paper on restructuring the rail industry:

> NR's announced organisational reforms are welcome and the regional business units it is setting up should bring decisions closer to passengers and freight users. But we do not think that NR's reforms yet go far enough. Further structural change is needed which:
>
> - creates around 10 independent infrastructure companies, separately licensed and regulated by ORR, from NR's current operations. These would be based largely on NR's current nine routes to ensure a good fit with train operations and should be rolled out by 2014
>
> [...]
>
> The priority should be to establish the infracos under NR ownership and, by the start of CP5, put them under separate ownership to achieve the maximum benefits of cost comparability and contestability. Given NR's size, each infraco would be a significant, FTSE-250 sized business with good economies of scale. The larger ones would be comparable in scale to continental EU operations such as ProRail (Netherlands), Trafikverket (Sweden) and Banestyrelsen (Denmark) and would, once a track record had been established, be attractive to potential investors.[74]

As indicated by ATOC, above, vertical integration has been raised in the context of re-privatising the infrastructure.[75] However, it is also supported by those who would like to see the railways brought back into public ownership. A June 2012 report by the rail trades unions said:

> [The] need for the different parts of the railway to be managed as a coherent whole arose repeatedly in our discussion with experts, several of whom pointed to the need for a 'guiding mind' to ensure that services, infrastructure and rolling stock are managed and developed in an integrated and consistent way […]
>
> [This would consist of] a single 'guiding mind' parent corporation spanning a subsidiary company responsible for passenger operations, infrastructure maintenance and enhancement, signalling and station management (which we term 'GB Rail Network

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72 "Network Rail in talks with train operator", *Financial Times*, 23 January 2012

73 op cit., *Reforming our railways: Putting the customer first*, para 4.27

74 ATOC, *A new structure for success on Britain's railway: An ATOC position paper on industry structural reform*, March 2011, pp3-4

75 see, e.g.: "Train operators call for breakup of Network Rail", *The Guardian*, 21 September 2010

> and Operations'), and a separate subsidiary company responsible for the 'essential functions' in relation to capacity allocation and access charges (which we term 'GB Rail Access'). This arrangement would provide the 'guiding mind' to coordinate railway functions (and to act as a single railway entity that national Government can deal with), whilst also meeting EU requirements for an arms-length relationship with Government and independence of the 'essential functions'.[76]

4.2 What might Labour do?

We do not know what NR might look like under a future Labour(-led) Government. In its pre-manifesto, published in December 2014, the Party said that it would "devolve decisions on transport to local authorities working together to ensure integrated networks across city and county regions" and that with regards to the railways it would "legislate so a public sector operator can take on lines and challenge private train operating companies on a level playing field".[77]

At the Party's Policy Forum at Milton Keynes in July 2014 Labour agreed a rail platform that included commitments to "tackle the monopoly market for rail rolling stock by giving Network Rail greater responsibility for developing a long term plan for procurement and leasing of new rolling stock" and "create a new guiding mind for the railways, bringning Network Rail together with a new representative passenger rail body to contract routes, co-ordinate services and skills in the industry, oversee stations, fares and ticketing, and ensure customer satisfaction across the network".[78] The then Shadow Secretary of State for Transport, Mary Creagh, gave further information on the 'guiding mind' proposal in a September 2014 article of *Passenger Transport* magazine:

> Network Rail rather than train operators will have lead responsibility for planning train services, and provide competition to the rolling stock leasing companies if Labour wins next year's election.
>
> The new responsibilities form part of a revised role set out for the company by shadow transport secretary Mary Creagh which would see it become the industry's "guiding mind".
>
> Other key tasks that would transfer to Network Rail under Labour's blueprint include overseeing stations, fares and ticketing; raising industry skill levels and ensuring customer satisfaction across the network.
>
> A new "representative passenger rail organisation" would be created to work alongside Network Rail in carrying out its new remit.
>
> "Simply put, there is no 'guiding mind' to plan future investment and to integrate the track and trains in the interest of passengers," Creagh said explaining the rationale for the new policy. The objectives, incentives and rewards for Network Rail and the train operating companies are misaligned, and sometimes even compete."
>
> Creagh added that tasking the company with procuring and leasing new rolling stock would provide much needed competition to the ROSCOs who she described as "making huge profits for doing very little, in a low risk environment".

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[76] Transport for Quality of Life, *Rebuilding Rail*, June 2012, pp66-67 & 69
[77] Labour Party, *Changing Britain Together*, December 2014, p21
[78] Labour Party, *Rail amendment: Policy Forum 2014*, July 2014 [via LabourList]

> Network Rail's new role will form the centrepiece of the party's rail policy for its election campaign.[79]

In her speech to Labour Party conference later that month Ms Creagh confirmed: "We will bring Network Rail and a new passenger rail body together to coordinate track and train operations, and look after passengers".[80]

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79 "Creagh: Network Rail will be 'guiding mind'", *Passenger Transport*, 3 September 2014
80 *Mary Creagh speech to Labour Conference*, 23 September 2014